

EXTERNAL AUDIT CIRCULAR No. 2



CONNECTICUT DEPARTMENT OF TRANSPORTATION

2800 BERLIN TURNPIKE, PO BOX 317546, NEWINGTON, CT 06131-7546

SUBJECT: Executive Compensation Costs

Release Date: January 1, 2012

This Circular presents interpretative guidance regarding executive compensation costs and includes examples for use in determining the allowability of such costs. Please refer to Chapter 7 of the 2010 edition of the AASHTO Uniform Audit & Accounting Guide for additional guidance.

I. DEFINITIONS

As used in these Connecticut Department of Transportation (CTDOT) External Audit Circulars—

"A/E firm" refers to any business entity that performs architectural, engineering, or other design-related services to CTDOT. In these Circulars, the term "consultant" is used synonymously with "A/E firm."

"ASBCA" refers to the Armed Services Board of Contract Appeals, which is composed of Administrative Judges. The ASBCA is the authorized representatives of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy and the Secretary of the Air Force, in hearing, considering and determining appeals by contractors from decisions of contracting officers or their authorized representatives or other authorities on disputed questions.

"AASHTO" refers to the American Association of State Highway and Transportation Officials

"Benchmark Compensation Amount" (BCA) is the maximum allowable compensation that may be charged against Federal-aid contracts for any *senior executive* of an A/E firm. The BCA is determined by the Office of Management and Budget's Office of Federal Procurement Policy (OFPP). The OFPP updates the BCA annually, generally in the month of May.

"Benchmark Corporation" refers to any *publicly-owned* United States corporation with annual sales in excess of \$50 million for the fiscal year.

"Compensation" is the total amount of wages, salaries, bonuses, deferred compensation, taxable fringe benefits, and employer contributions to defined contribution pension plans for the fiscal year, whether paid, earned, or otherwise accruing, as recorded in the consultant's cost accounting records for the fiscal year.

The "*DCAA Contract Audit Manual*" (CAM) is the definitive interpretation of FAR Part 31. The CAM is published semiannually by the Defense Contract Audit Agency (DCAA).

The "*Federal Acquisition Regulation, Part 31*" (FAR). The FAR is codified at 48 CFR Part 31. The FAR is the primary regulation that governs the acquisition of supplies and services with Federal funds.

The term "Federal-aid contracts" refers to agreements for the acquisition of supplies and services that are partially or fully funded from Federal sources. **Note:** In determining the allowability of costs, the treatment of State funded contracts is identical to that of Federal-aid contracts.

"FHWA" refers to the U.S. Department of Transportation's Federal Highway Administration

The term "senior executives" is defined as "the five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the home office or segment reports directly to the contractor's headquarters." FAR 31.205-6(p)(2)(ii)(B). Additionally CAS

4120 defines "segment" as "one of two or more divisions, product departments, plants or other subdivisions of an organization reporting directly to a home office usually identified with responsibility for profit and/or producing a product or service."

II. ISSUE

During an incurred-cost/pre-award audit, the auditor may encounter excessive or unsubstantiated compensation costs that have been charged to Federal-aid contracts.

III. ESTABLISHING ALLOWABLE COMPENSATION LEVELS

The Federal Acquisition Regulation [FAR] limits senior executives' compensation to the Benchmark Compensation Amount [BCA] as determined by the Office of Federal Procurement Policy [OFPP]. Section 808(b) of Pub. L. 105-85 defines BCA as –

The median amount of compensation provided for all senior executives of all benchmark corporations for the most recent year for which data is available at the time the determination ... is made.

The year 2010 BCA is \$693,951 and it applies to contract costs incurred as of January 1, 2010 and thereafter. The BCAs for years 2009, 2008 and 2007 were \$684,181, \$612,196, and \$597,912, respectively. In determining the BCA, the OFPP considers only compensation data from *benchmark corporations*, which are publicly-owned United State corporations with annual sales in excess of \$50 million for a given year.

The BCA applies to all Federal-aid contracts with commercial entities, regardless of whether the entities are publicly-traded or privately held; thus, there is great diversity in the size and complexity of firms that are governed by the BCA. For example, consider the differences between a privately-held engineering consulting firm with 60 employees and \$6 million of annual sales revenue versus publicly traded, multinational defense contractors like Lockheed Martin, UTC, and Northrop Grumman, with thousands of employees and billions of dollars of annual sales revenue. While large defense contractors clearly meet the definition of *benchmark corporation*, there are very few consulting firms that can make this claim. This is an important consideration since revenues generally are recognized as the most important factor in determining executive pay.

However, regardless of whether a firm meets the *benchmark corporation* definition, the BCA must not be construed as an entitlement or a guaranteed amount of cost recovery. Instead, all submitted contract costs, including compensation, are subject to the reasonableness provision of FAR 31.205-6. Privately held firms are subject to an additional restriction – no payment that represents a distribution of profits may be submitted as a cost against a Federal-aid contract.

Through its delegated contracting authority, the Connecticut Department of Transportation [CTDOT] has the authority to challenge the reasonableness of any individual element or sum of individual elements of submitted compensation costs. There is no presumption of reasonableness, and, once challenged, the consultant bears the burden of proof. This has been confirmed by the Armed Services Board of Contract Appeals [ASBCA] in its *Techplan* and *Information systems* decisions, as well as by several Federal sources, including representatives of the U. S. Department of Transportation's Office of Inspector General [U.S. DOT OIG] and Defense Contract Audit Agency [DCAA].

IV. DETERMINING REASONABLENESS: Compensation Study Performed by Consultant

The consultant must determine the reasonableness of executive compensation in a manner compliant with the criteria established in FAR 31.205-6, *Techplan Corporation*, and *Information Systems and Networks Corporation*. These criteria are fully discussed in Chapter 7 of the AASHTO Guide; accordingly, the consultant should prepare a compensation analysis in accordance with the procedures described in the AASHTO Guide [7.5 and 7.6]. Consultants must disallow costs in excess of the amount deemed reasonable.

The consultant must submit the compensation study to CTDOT for review. In cases where a consultant does not perform an acceptable compensation analysis, the National Compensation Matrix [NCM] described in Chapter 7.7 of the Audit Guide will be utilized when available. Until the NCM is developed, CTDOT will be utilizing the Ohio Department of Transportation compensation matrix which was developed using the criteria established in the *Techplan* and *Information Systems* cases. **No regional geographical adjustments will be made since this study was based upon national wage market data.**

REFERENCES

- FAR 31.201-3(a) (reasonableness – burden of proof rests with consultant).
- FAR 31.205-6(a)(6) and 31.205-6(b)(2) (compensation paid to related parties).
- FAR 31.205-6(a)(6)(ii)(B) (distribution of profits as unallowable contract costs).
- FAR 31.205-6(b)(2) (compensation for each employee must be reasonable for work performed).
- FAR 31.205-6(p) (adoption of BCA for government contracts with commercial organizations).
- FAR 31.205-6(p)(2)(ii) (definition of “senior executive”).
- FASB Statement No. 57 (Related Party Disclosures).
- DCAA Contract Audit Manual § 6-414 ().
- CTDOT External Audit Circular No. 1 (definitions, audit authority, and general guidance regarding the computation of indirect cost rates).
- Pub. L. No. 105-85, Stat. 1837, § 39©(3) (“benchmark compensation” definition and discussion).
- *Techplan Corporation*, ASBCA Nos. 41470, 45387, and 45388, 96-2 B.C.A. (CCH) P28, 426; 1996 ASBCA LEXIS 141
- *Information Systems and Networks Corporation*, ASBCA No. 47849, 1997 WL 381263 1997 WL 381263 (A.S.B.C.A.).
- Ohio Department of Transportation Audit Circular No. 2 for A/E Consulting Firms (2010 Update)
- AASHTO Uniform Audit & Accounting Guide [2010 Edition]